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# How To Fund The Budget

## INTRODUCTION

This chapter provides demographic, economic and assumptions, including detailed discussions of the national, State and local economies. Revenue sources, both tax supported and non-tax supported used to fund the County Executive's Recommended FY06 Operating Budget incorporate policy recommendations.

## ESTIMATING SIX-YEAR COSTS

### **Potential Factors**

The revenue projections of the PSP incorporate demographic assumptions based on Council of Governments Round 6.4A estimates, as prepared by M-NCPPC, and are based on fiscal and economic data and analyses used or prepared by the Department of Finance.

- County population, which was 936,000 in 2004, will continue to increase an average of 11,000 persons each year throughout the next seven years reaching over one million by 2011. This reflects an average annual growth rate of 1.1 percent which is below the average annual growth rate of 1.6 percent during the late 1990s.
- There were an estimated 345,000 households in the County in 2004. Household growth throughout the next seven years is now projected to range between 4,000 to 5,000 units each year, which translates into a growth rate of 1.2 percent annually. As a result, current projections estimate 376,000 households by the year 2011.
- County births, which are one indicator of future elementary school populations and child day care demand, are now projected to gradually increase, from an estimated 13,500 in 2003 to 13,700 by 2011.
- Montgomery County Public School enrollments are projected to increase over the next six years. However, the County can expect to see the rate of growth in school enrollment drop from 1,073 new students in FY06 to as few as 347 between FY08 and in FY09.
- Montgomery College enrollments are projected to increase from 21,224 in September 2005 to 24,520 in September 2010 (FY11). These estimates are based on a continuation of growth in fall enrollment.
- Other potential factors.

Using moderate economic and demographic assumptions to develop fiscal projections does not mean that all

possible factors have been considered. It is likely that entirely unanticipated events will affect long-term projections of revenue or expenditure pressures. Although they cannot be quantified, such potential factors should not be ignored in considering possible future developments. These potential factors include the following:

- Changes in the level of local economic activity,
- Federal economic and workforce changes,
- State tax and expenditure policies,
- Federal and State mandates requiring local expenditures,
- Devolution of Federal responsibilities to states and localities,
- Local tax policy changes,
- Changes in financial markets,
- Major demographic changes,
- Military conflicts and acts of terrorism, and
- Major international economic and political changes.

### **Policy Assumptions**

Revenue and resource estimates presented are the result of the recommended policies of the County Executive for the FY06 budget. Even though it is assumed that these policies will be effective throughout the six-year period, subsequent Council actions, State law and budgetary changes, actual economic conditions, and revised revenue projections may result in policy changes in later years.

### **Economic Assumptions**

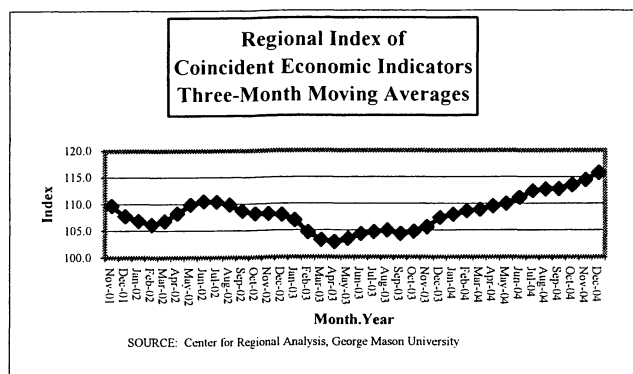
Revenue projections depend on the current and projected indicators of the national and local economy. National economic indicators also influence the County's revenue projections. Such indicators include short-term interest rates, mortgage interest rates, and the stock market. Local economic indicators include employment, retail sales, housing sales, residential and nonresidential construction, inflation, and consumer confidence. The assumptions for each of those indicators will affect the revenue projections over the six-year horizon. Because of the large presence of the federal government, both in terms of employment and procurement, Montgomery County's economy does not experience the volatility that is experienced nationally. Nevertheless, the County's economy is impacted by major fluctuations in federal spending and employment. For example, between 1992 and 1999, when the nation experienced significant economic growth, the County lost almost 6,400 federal jobs or 1.4 percent of the workforce. Through direct employment, grants in aid, and procurement, the federal government remains the largest

sector in the region and represents an estimated 29 percent of the County's economy in 2004.

The economic projections for the next six fiscal years assume a slow but sustainable growth rate. However, such projections are dependent on a number of factors – fiscal and monetary policy, consumer and business confidence, the stock market, mortgage interest rates, and geopolitical risks, especially international terrorism.

The national economy experienced remarkable growth during calendar year 2004. For the year, real gross domestic product (GDP) grew 4.4 percent with much of the growth attributable to consumer spending, business investment, and national defense. The economy in 2005 will depend, in large measure, on whether the consumer increases spending and business investment continues to expand. Prospects for economic growth are projected to continue into 2005 with real GDP expected to increase 3.6 percent. Total national payroll employment is projected to increase 1.6 percent year-over-year. Inflation is expected to remain below the 3 percent level 2005 with the overall inflation rate remaining below 3.0 percent through FY11.

Because the region's economy is significantly dependent on spending by the federal government, the recent surge in federal procurement boosted the region's economy during 2004. According to data from the Center for Regional Analysis, George Mason University, the Washington Coincident Index, which represents the current state of the region's economy, increased 7.6 percent in 2004 compared to the 3.4 percent for the National Coincident Index. Since the beginning of the 2004, the region's economy added 79,000 new jobs, the largest increase among the major metropolitan areas, and the unemployment rate has held steady at 3.2 percent, one of the lowest among the largest metropolitan areas in the country.



The recent surge in the local economy is also reflected in the performance of local businesses. Over the past two years, the Washington Post-Bloomberg regional index increased almost 67 percent compared to the 38 percent increase in the broad-based S&P 500 index. Retail sales were up 7.8 percent for the year compared to 6.5 percent in 2003.

Montgomery County experienced modest economic growth in 2004. The primary reasons for the County's modest economic improvement have been the lack of significant growth in private-sector jobs and a contraction in the growth of residential construction. As with the nation, inflation in the Washington-Baltimore region remains subdued while housing prices continue their meteoric rise.

A number of economic indicators for the County during 2004 experienced either modest improvement or weak performance. Foremost among the indicators that exhibited weak performance was payroll employment. After growing an average of 3.6 percent between 1997 and 2000, total payroll employment grew only 0.4 percent during 2001, 0.5 percent in 2002, and 0.4 percent during 2003, and 0.8 percent during the first six months of 2004. While the presence of the federal government, both in terms of employment and procurement, can have an effect on the County's economy, it represents only 9.0 percent of the County's total employment. Jobs in the private sector, which represents over 80 percent of total employment, declined in 2002 but increased modestly in 2003 and during the first half of 2004.

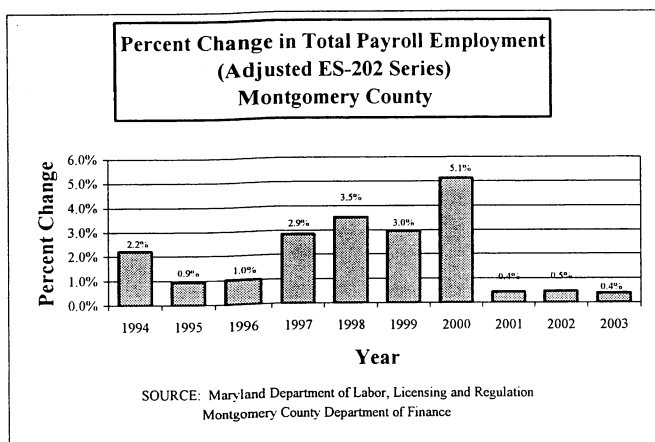
Retail sales recovered from a weak performance during 2002 and grew 4.0 percent during 2003 and 6.7 percent in 2004. After growing 6.1 percent and 6.6 percent during 1999 and 2000, respectively, sales grew 3.8 percent in 2001 and less than 1.0 percent during 2002.

New construction in the County experienced mixed results in 2004. Non-residential construction reflected in the amount of square footage and dollar value increased significantly compared to 2003. The number of new residential projects declined in 2004 with a drop of 20 percent in the number of single-family units built compared to 2003 but no change in the value of new construction. Vacancy rates for office space in the County declined in 2004 from 10.9 percent at the beginning of the year to 9.5 percent by December for Class A property.

It is against this backdrop of mixed economic indicators during 2004, that the Department of Finance has estimated projections for a number of economic indicators such as employment, personal income, inflation, and yields on investment income. Such estimates show a much slower pace of growth in employment and income compared to the late 1990s and 2000 but higher yields on investment attributed to the "measured" increases in the target rate for federal funds by the Federal Reserve Board.

Since the 1990-91 recession, total payroll employment in Montgomery County has experienced three distinct cycles: modest growth from 1992 to 1996 of 1.3 percent per year, significant growth from 1997 to 2000 of 3.6 percent per year, and since 2001, very weak growth averaging 0.4 percent per year. Between 1992 and 1996, an average of 4,700 jobs per year was created in the County. Between 1997 and 2000, the average number of jobs accelerated to

almost 14,500 per year. Since 2001, the County averaged approximately 1,900 new jobs per year. During the first half of 2004, total payroll employment increased by 3,600 jobs compared to the same period in 2003. Gains during the first half of 2004 were solely attributed to an increase in the private sector of 4,450 jobs, while the public sector experienced a net loss of 850 jobs. Employment is one of the most important economic drivers in determining the economic condition and outlook for Montgomery County. The employment situation and actual and potential job growth affect personal income, retail sales, the housing market, and new construction and development. In turn, personal income, the housing market, and new construction affect the revenue capacity of the County in the near- and long-term.



Based on this assessment of the employment situation in Montgomery County, the Department of Finance assumes that employment will grow at a rate comparable to the early to mid-1990s of approximately 1.0 percent per year, as opposed to the rapid growth experienced during the late 1990s and 2000. However, the number of jobs is one indicator of the employment situation in the County, the other important factor is the growth in wages and salaries.

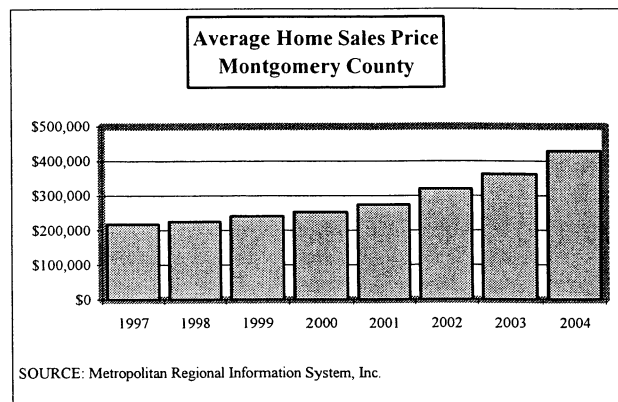
From 1996 through 2000, the average weekly salary of employees in Montgomery County increased an average of 5.0 percent per year. However, reflecting weaker labor market conditions, wage growth decelerated to less than 4.0 percent between 2001 and 2003. Based on data for the first half of 2004, average wages increased 5.8 percent compared to the first half of 2003. If that rate does not change over the second half of the year, it will be the largest average wage increase since 2000. Such acceleration in wage growth will partially offset the meager growth in payroll employment such that total personal income for the County will grow at a slower pace during the decade compared to the latter part of the 1990s and 2000.

The County's unemployment rate remained well below the region, State, and national average during the first half of 2004. For December of 2004, the County's rate at 2.0 percent was 1.7 percentage points below the State average and 3.7 percentage points below the national average.

Although the County employment base may not be growing at a significant pace, the unemployment rate suggests that the public sector, both federal and local, is providing a stable foundation against significant volatility in the labor market and that the County may have reached full employment.

As a result of a combination of low job growth but strong gains in wages and salaries, the Department of Finance assumes that total personal income will grow at an average rate of 5.2 percent per year from 2006 through 2011. This rate is slightly above the average rate of 3.8 percent between 2000 and 2002 but well below the average rate of 7.4 percent between 1997 and 2000, a period of phenomenal employment and income growth for the County. If employment, wages and salaries, or both grow at a stronger pace than is currently assumed, then personal income may exceed the average annual growth rate 5.1 percent that occurred in the 1990s.

The housing market in Montgomery County continues to be a remarkable story. It remains an economic puzzle when compared to other economic indicators during the recent business cycle. During 2004, the sale of homes in the County increased 7.4 percent for the year while average prices continued their dramatic increase at 18.3 percent. This follows a year when housing sales increased 2.9 percent and average prices increased 13.2 percent. Such a remarkable pattern can be attributed to two factors: historic low mortgage rates and a limited supply of housing in the County.



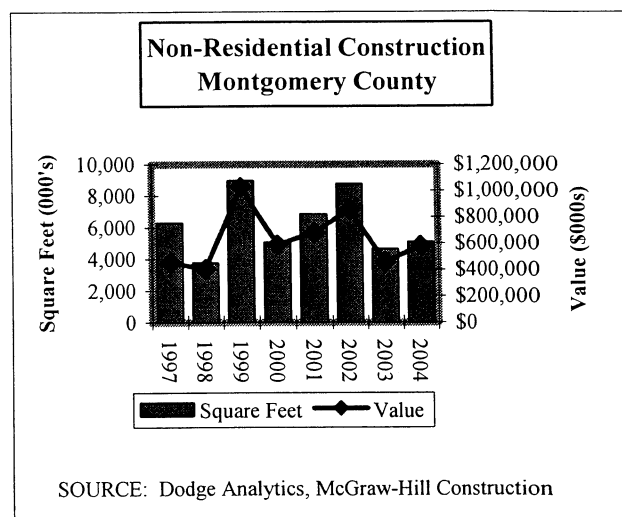
As measured by the Consumer Price Index for All Urban Consumers (CPI-U), inflation in the Washington-Baltimore consolidated statistical metropolitan area remained subdued during 2004. Consumer prices increased 2.8 percent in the region, the same rate in 2003. The core inflation rate, which is the CPI excluding the volatile food and energy prices, increased 1.8 percent during 2004, which was lower compared to the 2.4 percent during 2003. The Department of Finance assumes that inflation will continue to remain subdued during the next six years with an average inflation rate of 2.6 percent, which is below the current rate. However, if either a geopolitical event attributed to the continued war on terrorism that may lead to potential disruptions in the

supply of oil, the price of fuel and energy may increase significantly in the near term pushing inflation above the expected average.

Using sales tax receipts as a measure of the level of retail sales for the County, sales increased 6.7 percent during 2004 compared to 4.0 percent in 2003. The sale of nondurable goods, which includes food and beverage, apparel, general merchandise, and utilities and transportation, increased 5.9 percent and purchases of durable goods were up 9.7 percent. With the slight growth in employment and personal income in 2005 and 2006, the Department of Finance assumes that the growth in retail sales in 2005 and 2006 should mirror 2004 with purchases of nondurable goods growing faster than purchases of durable goods.

Construction is a cyclical activity that can have a significant effect on a local economy and employment owing to secondary and tertiary effects on construction supply and services industries. Starts and permits are key indicators of the near-term economic condition of the housing industry and are considered leading indicators for the local economy. Of lesser note, new single-family home sales and construction outlays are important indicators for monitoring the level of current investment activity. Construction starts measure initial construction activity as opposed to construction permits, which measure planned activity. However, starts and permits closely track each other and as such, a moving average provides a more reliable indicator of the housing trend compared to month-to-month changes. Construction outlays are the value of new construction put in place. In contrast to permit and start information, outlays refer to actual construction rather than planned (permits) or initiated (starts) activity. The primary source of such data is Dodge Analytics of McGraw-Hill Construction.

The boom in non-residential construction that occurred in 2001 and 2002 and ended in 2003 recovered in 2004. Although the number of non-residential construction projects declined in 2004, the amount of square footage added to existing capacity and the dollar value of construction increased during the year. The number of starts declined to less than 240 in 2004 compared to over 300 construction starts in 2003, a decrease of 23.9 percent. After adding an average of 7.8 million square feet of capacity in 2001 and 2002, and a decline to 4.6 million square feet in 2003, over 5.0 million square feet were added in 2004, an increase of 9.3 percent. The increase in non-residential construction occurred across most types of properties with commercial property up 14.4 percent. Other sectors that experienced increases included the education and science facilities, and hospital and health treatment facilities. Office and bank buildings, however, declined nearly 33 percent in response to the high vacancy rates experienced during the past two years.

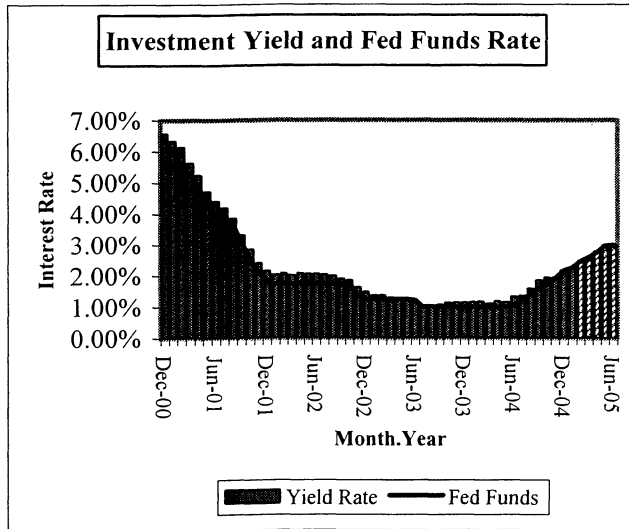


With the expansion of non-residential capacity during 2001 and 2002, vacancy rates in the County have also risen. Although slightly lower than some jurisdictions in the Washington metropolitan area, the rate for Class A office space quadrupled from a low of 2.5 percent in December 2000 to 9.5 percent by December 2004. This reflected an inventory of 2.7 million square feet of vacant office space (Class A property). Compared to other local jurisdictions, Fairfax County has a vacancy rate of 10.7 percent with 6.7 million square feet of vacant office space, the City of Alexandria and Arlington County have a vacancy rate of 8.1 percent with 2.1 million square feet of vacant office space, and the District of Columbia has a vacancy rate of 7.7 percent with 4.8 million square feet of vacant office space in December 2004. With the modest decline in the vacancy rate, non-residential construction will continue to expand albeit at a slow pace in the near term in order to maintain a balance between supply and demand.

The number of new residential projects also declined dramatically in 2004. The number of construction starts declined 6.7 percent, which followed a drop of 49.0 percent in 2003, but the amount of new square footage increased 3.2 percent. The value of the projects increased slightly from \$676.6 million in 2003 to \$677.7 million in 2004. With the decline in the number of projects, but an increase in square footage, developers are building larger and more expensive units.

The number of new one-family houses built in Montgomery County fell sharply from 4,172 units in 2002 to 2,096 in 2003 and to 1,650 in 2004. With that rate of decline, less than a third new units are being built to accommodate annual household growth. Maryland National Park and Planning Commission (M-NCPPC) estimates that the number of households in the County will increase 1.2 percent per year over the next six years compared to a 1.5 percent annual growth rate experienced during the late 1990s through 2004.

The Federal Reserve Board through its Federal Open Market Committee (FOMC) has instituted a measured monetary policy by increasing the target rate for federal funds from 1.25 percent on June 30, 2004 to 2.50 percent on February 2, 2005. Because of the FOMC's recent policy change, the investment yield on short-term financial instruments by the County reflected that increase. The Department of Finance estimates that yields on the County's short-term money market investments will steadily increase from 2.15 percent in FY05 to 5.25 percent by FY11.



### Demographic Assumptions

The scenario is based on demographic assumptions resulting from COG Round 6.4A estimates as projected by M-NCPPC. This forecast predicts that the County will continue to experience moderate population growth in the range of 0.8 to 1.3 percent annually, with slightly stronger growth in the first three years of the forecast period. In addition to a net expansion of the base, much of the expected increase in population will result from immigration. This results in a rise of population from an estimated 936,000 in 2004 to over 1,000,000 by 2011. Besides general population changes, demographic forecasts anticipate a continuing increase in school-age population and, hence, public school enrollment. A Trends and Projections chart located at the end of this chapter provides several demographic and planning indicators.

### REVENUE SOURCES

The major revenue sources for all County funds of the Operating Budget and the Public Services Program are described below. Revenue sources which fund department and agency budgets are included in the respective budget presentations. Six-year projections of revenues and resources available for allocation are made for all County funds. This section displays projections of total revenues available for the tax supported portion of the program.

Tax supported funds are those funds subject to the Spending Affordability Guideline (SAG) limitations. The SAG limitations were designed and intended to provide guidance prior to the preparation of the recommended budget as to the level of expenditure that is affordable based on the latest revenue estimates.

The PSP also includes multi-year projections of non-tax supported areas. These funds represent another type of financial burden on households and businesses and, therefore, should be considered in determining the "affordability" of all services that affect most of the County's population. Projections for non-tax supported funds within County government are presented in the budget section for each of those funds. A proposed Taxes and User Charges for an Average Homeowner chart displays the total burden on the average household taxpayer and business including solid waste and water and sewer charges. This chart is found at the end of the chapter.

### IMPACT ON REVENUES AND THE CAPITAL BUDGET

The use of resources represented in this section includes appropriations to the Operating Funds of the various agencies of the County as well as other resource requirements, such as current revenue funding of the Capital Budget, Debt Service, and Fund Balance (operating margin). These other uses, commonly called "Non-Agency Uses of Resources," affect the total level of resources available for allocation to agency programs. Some of these factors are determined by County policy; others depend, in part, on actual revenue receipts and expenditure patterns.

The level of PSP-related spending indirectly impacts the local economy and, hence, the level of County revenues. However, the effect on revenues from expenditures of the Executive's Recommended Operating Budget and PSP are expected to be minimal. The PSP also impacts revenues available to fund the Capital Budget. The revenue projections included in this section subtract projected uses of current revenues for both debt eligible and non-debt eligible capital investments. Therefore, the Executive's Recommended Operating Budget and PSP provide the allocations of annual resources to the Capital Budget as planned for in the County Executive's Amendments to the FY05-10 CIP (as of January 15, 2005). These allocations will vary because of adjustments to current revenues for the CIP as part of the Executive's Recommended Operating Budget.

### Prior Year Fund Balance

The prior year fund balance for the previous fiscal year is the audited FY04 closing fund balance for all tax supported funds. The current year fund balance results from an analysis of revenues and expenditures for the balance of the fiscal year. Prior year fund balance for

future fiscal years is assumed to equal the target fund balance for the preceding year.

### Net Transfers

Net transfers are the net of transfers between all tax supported and non-tax supported funds in all agencies. Usually, the largest single items are the earnings transfer from the Liquor Control Fund to the General Fund and the transfers for indirect costs from the non-tax supported funds. These are offset in part by transfers to non-tax supported funds, the largest of which is the transfer from the General Fund to Montgomery Housing Initiative to support the Executive's housing policy. The payment from the General Fund to the Solid Waste Disposal Fund for disposal of solid waste collected at County facilities is the next largest transfer to a non-tax supported fund. The level of transfers is an estimate based on individual estimates of component transfers.

### Debt Service Obligations

Debt service estimates are those made to support the County Executive's Amendments to the FY05-10 Capital Improvements Program (as of January 15, 2005). Debt service obligations over the six years are based on servicing debt issued to fund planned capital projects, as well as amounts necessary for long-term leases. Debt service requirements have the single largest impact on the Operating Budget/Public Services Program by the Capital Improvements Program. The Charter-required CIP contains a plan or schedule of project expenditures for schools, transportation, and infrastructure modernization. Approximately 57 percent of the CIP is funded with G.O. bonds. Each G.O. bond issue used to fund the CIP translates to a draw against the Operating Budget each year for 20 years. Debt requirements for past and future G.O. bond issues are calculated each fiscal year, and provision for the payment of Debt Service is included as part of the annual estimation of resources available for other Operating Budget requirements. As Debt Service grows over the years, increased pressures are placed on other PSP programs competing for scarce resources.

In accordance with the County's Fiscal Policy, these obligations are expected to stay manageable, representing less than 10.0 percent of General Fund revenues. Maintaining this guideline ensures that taxpayer resources are not overextended during fiscal downturns and that services are not reduced over time due to increased Debt Service burdens.

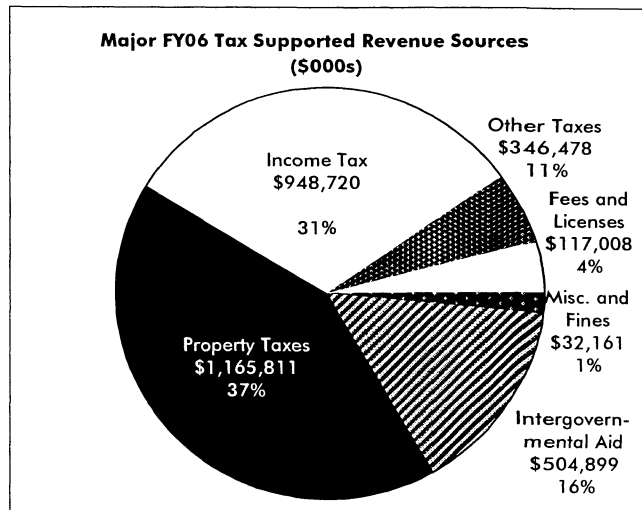
The State authorizes borrowing of funds and issuance of bonds up to a maximum of 6.0 percent of the assessed valuation of all real property and 15.0 percent of the assessed value of all personal property within the County. The County's outstanding G.O. debt, plus short-term commercial paper, plus the Maryland Industrial and Commercial Redevelopment Fund (MICRF) loan, as of June 30, 2004, is 1.6 percent of assessed value, well within

the legal debt limit and safely within the County's financial capabilities.

### CIP Current Revenue and PAYGO

Estimates of transfers of current revenue and PAYGO to the CIP are based on the most current County Executive recommendations for the Capital Budget and CIP. These estimates are based on programmed current revenue and PAYGO funding in the six years, as well as additional current revenue amounts allocated to the CIP for future projects and inflation.

### Revenue Stabilization



Mandatory contributions to the Revenue Stabilization Fund (Rainy Day Fund) are made if certain revenues increase above their budgeted projections and/or if projected revenue growth is stronger than in a selected historical period. Revenues include County Income Tax, Transfer Tax, Recordation Tax, and General Fund Investment Income. The projection assumes that a mandatory transfer of \$5.2 million will be made to this fund at the end of FY05 reaching a fund balance of \$101.2 million, which is the result of higher than previously estimated income tax revenues and transfer and recordation taxes. However, the projection for FY06 assumes that no mandatory transfer will be made to this fund at the end of the fiscal year. Because of higher than expected revenue collections six years in a row, in addition to the two discretionary transfers made in FY95 (\$10.0 million) and FY96 (\$4.5 million), the Revenue Stabilization Fund reached its maximum allowable fund size of \$95.9 million at the close of FY04 with a mandatory contribution of \$8.8 million.

Since the fund has reached more than half of its maximum fund size, interest earned from the fund must fund PAYGO expenditures in the CIP fund. The estimate of the interest in FY05 is \$2.1 million. A similar funding of PAYGO from earned interest was made in FY02 (\$2.2 million), FY03 (\$1.3 million), and FY04 (\$1.1 million). Due to a projected growth in revenues, the maximum

allowable fund size is projected at \$133.8 million by FY11. However, barring future discretionary or mandatory contributions to the fund, the fund will remain at the current \$101.2 million level through FY11.

## **Other Uses**

This category is used to set aside funds for such items as possible legal settlement payments and other special circumstances such as set-aside of revenues to fund future years.

## **Reserves**

The County will maintain total reserves for tax supported funds that include both an operating margin reserve and the Revenue Stabilization Fund (or "Rainy Day Fund"). For tax supported funds, the budgeted total reserve of the operating margin and the Revenue Stabilization Fund should be at least 6.0 percent of total resources (i.e., revenues, transfers, prior year undesignated and designated fund balance).

## **REVENUE ASSUMPTIONS**

Projections for revenues are included in six-year schedules for County Government Special Funds and for Montgomery College, M-NCPPC, and WSSC in the relevant sections of this document. See the MCPS Budget Document for six-year projections of MCPS funds. Projections for revenues funding County government appropriations are provided to the Council and public as fiscal projections. Such projections are based on estimates of County income from its own sources such as taxes, user fees, charges, and fines, as well as expectations of other assistance from the State and Federal government. The most likely economic, demographic, and governmental policy assumptions that will cause a change in revenue projections are included in this section.

## **TAX REVENUES**

Tax supported revenues come from a number of sources including but not limited to property and income taxes, real estate transfer and recordation taxes, intergovernmental revenues, service charges, fees and licenses, college tuition, and investment income. In order of magnitude, however, the property tax and income tax are the most important with 47.4 percent and 38.6 percent, of the estimated total tax supported revenues in FY06. The third category is the combined real estate transfer and recordation taxes with a 7.5 percent share. Income and transfer and recordation taxes are the most sensitive to economic and, increasingly, financial market conditions. By contrast, the property tax exhibits the least volatility.

In the late 1990s and early 2000s, the property tax stood in the shadow of the income tax in terms of growth. In fact, in FY99 measured by General Fund revenues, the income tax surpassed the property tax for the first time as the largest tax source in the County. After all, the low single-

digit growth in property tax revenue was dwarfed by the double-digit growth in the income tax. But with all this explosive growth in the income tax also came considerable volatility. For that reason, it was a welcome sign to observe that the property tax – the most stable of all revenue sources – gained considerable ground at a time that the income tax experienced considerable weakness. From a tax policy point of view, FY06 marks the third consecutive year in which the property tax regains its prominent position with growth in revenue – both in absolute and relative terms – well above the income tax. As a result, future revenue growth for the County is more balanced and less volatile, albeit with slower growth compared to the late 1990s.

## **Property Tax**

**Total estimated FY06 property tax revenues of \$1,165.8 million are 9.2 percent above the revised FY05 estimate.** Property tax revenues for FY06 are estimated based on the recommended rate schedule (levy year 2005) applied to the respective assessable bases. The County Executive recommends a two cent reduction in the property tax rate to help alleviate the tax burden on the County's residents, and wants to work with the County Council to target a portion of this relief to those living on limited or fixed incomes. The recommended schedule reflects a two-cent reduction from the Levy Year 2004 schedule. The general countywide rate assumed for FY06 is \$0.694 per \$100 of assessed real property, while a rate of \$1.735 per \$100 is levied on personal property. In addition to the general countywide tax rate, there are special district area tax rates. In aggregate, the property tax rate for both real and personal property in Montgomery County is estimated at \$1.023 per \$100 of assessed value in FY06. This rate may vary depending on the geographic location and number of special taxing district rates levied on the property. The 1990 Charter amendment (FIT) limits the growth in property tax revenues to the sum of the previous year's estimated revenue, increased by the rate of inflation, and an amount based on the value of new construction and other minor factors. This Charter limit, however, may be overridden by a super-majority vote of seven of the nine members of the County Council. Growth in the previous calendar year's CPI-U for the Washington-Baltimore Consolidated Metropolitan Statistical Area is used to measure inflation. Since reassessments are growing faster than the rate of inflation for the third consecutive year, current rates generate revenues that are \$62.5 million above the Charter limit for FY06.

The Countywide total property tax assessable base is estimated to increase 11.7 percent from a revised \$102.4 billion in FY05 to \$114.4 billion in FY06. The base is made up of real property and personal property. In FY06, real property will amount to \$110.5 billion with the remaining \$3.9 billion in personal property. The growth in the property base has fluctuated significantly over time, with an average of 10.0 percent growth during the late 1980s and early 1990s, followed by considerable



deceleration during the rest of the 1990s with base growth generally close to 2.0 percent. The real property base changes as a result of additions to the base (i.e., new construction) and changes to the existing base (i.e., reassessments of existing properties). Reflecting changes in new construction and a dramatic pick-up in reassessments, the base is expected to grow a revised 10.3 percent in FY05 and is projected to grow 12.2 percent in FY06 – the largest growth since FY92.

The real property base is divided into three groups based on their geographic location in the County. Each group is reassessed tri-annually by the State Department of Assessments and Taxation (SDAT) which has the responsibility for assessing properties in Maryland. The amount of the change in the established market value (full cash value) of one-third of the properties reassessed each year is phased in over a three-year period. Declines in assessed values, however, are effective in the first year. Because of the different phase-ins of increases and declines during periods of modest reassessment growth, the reassessment cycle for a particular group may produce either no growth or a decline in the first year, followed by reassessment gains in the two subsequent years. Growth in reassessments will jump 65.0 percent (69.3 percent for residential properties and 49.7 percent for commercial properties) for Group II in FY06. This follows a 36.3 percent increase (47.0 percent for residential properties and 16.1 percent for commercial properties) for Group III in FY04 and 51.8 percent (55.5 percent for residential properties and 26.1 percent for commercial properties) for Group I in FY05. This growth shows a sharp improvement in recent years from most of the 1990s and early 2000s, and now even exceeds the high double-digit growth in reassessments observed during the late 1980s.

There is a ten percent annual assessment growth limitation for residential property that is owner-occupied. As a result of this “homestead tax credit,” taxable reassessments in Montgomery County may not grow more than ten percent in any one year. Due to strong reassessment growth in the late 1980s and early 1990s, this assessment limitation credit topped the \$2.5 billion mark in FY92 (using the current 100 percent full cash value method). As growth in home prices decelerated in subsequent years, reassessments either declined or grew less rapidly. The homestead tax credit reflects this trend, with the total credit dropping steadily to \$48 million in FY01. However, as the real estate market rebounded in the County starting in the late 1990s, home prices rose at a faster clip causing a sharp increase in reassessments. This is reflected in an increase in the credit to \$1.33 billion in FY04, \$3.80 billion in FY05, and an estimated \$8.76 billion in FY06, which is an all time record. The outlook for the remainder of the six-year forecast period is for the homestead tax credit to continue the explosive trend through FY08 then moderate by fiscal year 2012.

Decreases in the personal property base beginning in FY04 reflect a weak regional economy producing a lower

number of new businesses and associated investments, and exacerbated by recent tax law changes, including exemptions (e.g., manufacturing, Research and Development, and certain computer software) and depreciation rules (e.g., for computer equipment). Personal property includes public utility equipment, business furniture and equipment, and computers. According to SDAT, the corporate personal property base is projected to decrease 0.1 percent in FY06. The public utility portion, which accounts for 38.1 percent of the personal property base, is projected to decline 2.5 percent in FY06. The public utility personal property base, which accounted for slightly less than half prior to the electric deregulation process, now exempts 50 percent of personal property used to generate electricity. The 50 percent exemption was phased in during FY01 (25 percent) and completed in FY02 (50 percent), and exempts an estimated \$124 million in personal property. In order to prevent a revenue shortfall, the Maryland Legislature provides for an annual grant equal to the amount lost in revenues, which is expected to be \$2.8 million in Montgomery County in FY05.

The real property base of \$110.5 billion in FY06 is estimated to grow \$12.0 billion compared to a revised FY05 estimate, the result of \$1.2 billion in additions to the base from new construction, and \$15.6 billion in reassessments, offset by a \$5.0 billion rise in the homestead tax credit. The level of new reassessments is a near-term record high in the County and represents substantial growth in the property tax base. Construction is projected to decline in FY06, then is expected to grow from just above \$1.1 billion in the FY06 to well above \$1.5 billion by FY11. Similarly, reassessments remain the largest contributor to the base growth during this six-year forecast period. Reflecting a phase-in of the 65.0 percent jump for Group II, an equally robust 40.0 percent reassessment growth is expected for Group III in FY07 and 22.4 percent for Group I in FY08. As a result of these trends, the total assessable base is projected to steadily grow to 10.3 percent by FY07 before moderating to a growth rate of 8.8 percent by FY11.

A County Taxes as a Share of Personal Income chart shows the share of personal income that the average County resident pays for all taxes. Fiscal years 1995 through 2004 are actuals, FY05 is an estimate, and FY06 is based on the County Executive’s Recommended Budget. The Average Household Tax Burden chart shows the average of all County taxes paid by the average household in both nominal and inflation-adjusted numbers by fiscal year (base year is FY95). The Average Household Property Tax Burden chart shows the average of County property taxes paid by the average household in inflation-adjusted numbers by fiscal year. These charts are found at the end of the chapter.



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## Income Tax

**Estimated FY06 income tax revenues of \$948.7 million are 3.0 percent above the revised FY05 estimate.** This increase reflects the administrative changes to the income tax distribution to the County by the Comptroller of Maryland such that the increase in FY06 is affected by the offset in the September 2005 distribution due to the accelerated cash flows of the quarterly distributions in FY04 and FY05. Without that offset, revenues would have increased 5.2 percent. Enacted in 1967 as a State-collected local surtax on the State income tax, the Montgomery County local rate began at 20 percent in 1967, increased to 35 percent in 1968, 45 percent in 1969, and was 50 percent of the State tax from 1970 through 1991. The local rate was increased from 50 percent to 55 percent for calendar 1992 and increased to 60 percent for calendar 1993. Effective tax year 1998, the State of Maryland enacted a five-year phased-in ten percent income tax cut, which results from a doubling of the personal exemption to \$2,400 and a drop in the tax rate from 5.0 percent to 4.75 percent. Due to a de-coupling of State and local income tax base calculations in 1998, income tax revenues for the counties and the City of Baltimore are not affected by this change. However, since tax liability for local tax computation purposes is different from the tax liability computation for State taxes, it required taxpayers to compute the 1998 local tax using the pre-1998 State rate and exemption schedules. Due to the increased complexity of computing the 1998 tax, the Maryland State Comptroller proposed an alternative method - one that simplified the tax return (including re-introduction of the "short-form") and maintained revenue neutrality for local jurisdictions. This new method computes a local tax rate, applied to Maryland State taxable income. Since local jurisdictions had different piggyback tax rates, it also required different income tax rate schedules for each local jurisdiction. In addition, annual increases in exemption amount reduced State taxable income through tax year 2002 - the year in which the State's tax relief program was fully phased in. Since State taxable income declined over the period 1999 through 2002, in order to maintain revenue neutrality, the local income tax rate increased slightly during that period. In 2002, once the exemptions were phased in, the local income tax rate remained unchanged. This method was enacted by the State Legislature and became effective tax year 1999. Montgomery County adopted a local income tax rate of 3.01 percent for tax year 1999. Note that, under the pre-1998 State tax relief scenario, the Montgomery County income tax rate would have been 3.00 percent (60 percent piggyback tax based on the State's 5.0 percent income tax rate).

Effective tax year 2000, the County reduced the "piggyback" tax rate from 60 percent to 58 percent. As a result of this change, the new local income tax rate schedule became: 2.90 percent (2000), 2.92 percent (2001), and 2.95 percent (2002 and 2003). Effective with tax year 2004, the County Council increased the rate to the maximum allowed under State law (3.20 percent).

Total income tax revenues are estimated at \$948.7 million in FY06, which reflects a 3.0 percent increase from the revised FY05 estimate. Growth has been slowing over the past few years reflecting moderation in the trend. For example, adjusted for the rate cut, the percent change in withholdings and estimated payments have declined steadily from a recent peak of 12.4 percent in FY00 to -1.8 percent in FY03. However, withholdings and estimated payments increased 4.9 percent in FY04.

Since, during any one fiscal year, the County receives income tax distributions pertaining to, at least, three different calendar tax years, it is important to analyze the data on a calendar year basis. During the 1990s, average annual tax liability in the County grew considerably slower in the first half (7.5 percent) of the decade compared to the second half (10.4 percent). During the second half of the 1990s, quarterly income tax distributions grew rapidly, with ten percent growth rates in the years 1997 through 1999. However, such growth decelerated rapidly to only 6.8 percent in 2000, 1.1 percent in 2001, and 1.4 percent in 2002. In addition to the quarterly distributions that represent withholdings and estimated payments, receipts from late filers who had underestimated their tax liability jumped to unprecedented levels during the late 1990s and 2000. For example, while a total of only \$37 million was received for tax year 1990, that amount gradually increased 450 percent when it peaked at \$204 million in 2000, but fell sharply in the two subsequent years to \$98 million by 2002. As taxpayers underestimate their tax liability from, generally, non-employment related earnings, additional payments are made when tax returns are filed. Taxpayers with more complicated tax returns, reflecting significant non-employment related earnings such as stock options and capital gains, increasingly file for an extension. Since taxpayers may file for two extensions (August 15<sup>th</sup> and October 15<sup>th</sup>), income tax receipts from late filers are distributed to the County in September and January. These late filer distributions reflect significant shifts in one-time tax liability and, thus, represent the most volatile component of the income tax. Even though, in aggregate, this tax liability may continue to shift over a longer period of time, the shift remains one time in the sense that tax liability changes as a result of the one-time exercise of a stock option or sale of stock at a price that is different from the original issuance or purchase. Once that action has been taken, gains (or losses) are recognized, with no addition to future tax liability. By contrast, employment growth is an addition to the base that increases tax liability through wage growth in future years and is, thus, a more predictable indicator of future revenue growth.

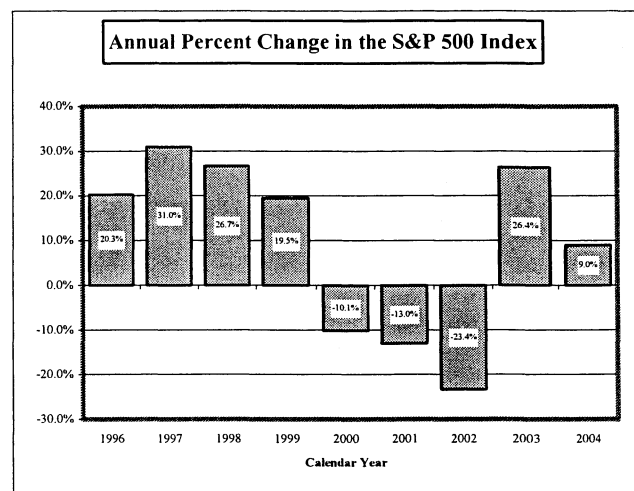
With a disproportionately large share of wealthy taxpayers in the County, the correlation between stock market returns, through stock options and capital gains, and income tax receipts is particularly relevant in Montgomery County. However, in contrast to the effect of general stock market conditions impacting most taxpayers, wealthy taxpayers, including those selling significant ownership

shares, may have taxable capital gains in years that all stock market indexes are negative or significant capital losses that carry forward during years of market appreciation such as 2003 and 2004. Data for tax year 2000, a year that the S&P 500 declined 10.1 percent in value and quarterly statements for most investors showed declining portfolio balances indicate that late filer payments jumped to a record \$204 million. Moreover, data for the top fifty taxpayers in that year show that taxable income jumped 67 percent in what was, by most accounts, not a particularly good year. Analysis of aggregate income tax data for the County suggests that realized taxable capital gains increased from \$1.483 billion in 1996 to an estimated record \$6.818 billion in 2000 but fell 44.8 percent in 2001 to an estimated \$3.765 billion and an additional 29.9 percent in 2002 to an estimated \$2.640 billion. With the rebound in the stock market in 2003 and 2004, realized taxable capital gains are expected to increase 20.4 percent to \$3.180 billion and 5.5 percent to \$3.355 billion, respectively. As a result, in contrast to an 18.5 percent share of the State's employment base, the County had approximately 60 percent share of capital gains in Maryland and more than one percent of the entire nation during the record year of 2000. Capital gains as a share of the County's total income also increased from 8.6 percent in 1997 to an estimated 17.5 percent in 2000 but declined to an estimated 8.2 percent in 2004, nearly the same share as in 1997. If, in contrast to the unprecedented gains in the stock markets, returns would have followed the historical growth path of 8 percent, and assuming a similar growth for realized capital gains, then tax liability for tax years 1998 through 2000 would have been close to \$260 million less than was received by the County in income tax revenues. An important conclusion is that, while non-employment earnings related to stock market performance are always volatile, such as in the periods 1995-99 and 2000-02, it is even more volatile when earnings increase dramatically for only a few taxpayers at a time that market forces reduce income for the vast majority of taxpayers, such as in 2000.

In addition to the impact on income tax receipts from non-employment related earnings from 1994 through 2000, the employment base improved substantially as well with the County adding nearly 76,000 private-sector jobs offsetting a drop of 2,150 public-sector jobs for a net gain of slightly less than 74,000 jobs or approximately 10,500 jobs per year. The County benefited from the record-long economic expansion during this period. At the same time, due to the tight labor market in the County, with close to two percent unemployment, wages were growing rapidly. However, between 2001 and 2003, the County's labor market deteriorated, with a total loss of approximately 950 private-sector jobs which were offset by an increase of nearly 4,900 public-sector jobs for a net gain of less than 45,800 payroll jobs or approximately 1,900 jobs per year – or an 82 percent decline compared to the 1994-2000 period. With such a weaker economic growth trend, payroll employment is expected to continue to grow 1.6 percent in the initial year of the six-year forecast period,

increasing to 1.7 percent from 2006 through 2010. Also, wage growth is expected to continue to expand just over four percent. With the projected growth in employment and wages and salaries, personal income is projected to grow between a low of 3.7 percent in FY07 to a high of 5.3 percent in FY10 with a six-year average of 4.6 percent per year during the six-year forecast period.

Reflecting a sharp downturn in all stock market returns between 2000 and 2002, estimated payments for the State of Maryland, usually taxes paid for non-employment related earnings, indicate that following growth of 20 percent in 2000, subsequent payments turned negative in 2001 or a decrease of 8.1 percent, 2002 or a decrease of 8.8 percent, and 2003 or a decrease of 0.5 percent. Moreover, since Montgomery County has a disproportionately large share of wealthy taxpayers, the sustained decline in estimated payments for the entire State of Maryland is more than likely to understate the drop in Montgomery County. In response to the dramatic turnaround in the stock market beginning in 2003 and continuing into 2004, estimated payments increased 16.2 percent in tax year 2004.



In FY04, the Maryland State Comptroller implemented an administrative change to the quarterly distribution of revenue collections to the County. The Comptroller has instituted a procedure expediting the submittal of withholdings by employers. Previous to the change, the Comptroller received employers' withholdings on the 15<sup>th</sup> day of the subsequent month. The new procedure requires employers to submit their withholdings within three business days. As a result, the Comptroller now accelerates the August distribution to the month of June for all counties and the City of Baltimore.

A second administrative change accelerated distributions of unclaimed withholdings, which are usually held for three years. As a result, fifty percent of three years of unclaimed withholdings (tax years 2001, 2002, and 2003) along with the regular unclaimed withholdings from tax

year 2000 were combined into one distribution for June 2004. Under this proposal, the State of Maryland claimed the other 50 percent.

A third administrative change reduced the unallocated percentage by 3 percentage points and used that reduction to accelerate the quarterly distributions. Essentially, the percentage point reduction does not change the total tax liability; rather it accelerates the cash flow distributions for FY04 and FY05 quarterly distributions with the first offsetting reduction in the September 2005 distribution (FY06). Because of such offset in September, the estimated growth in revenues for FY06 is 3.0.

## **Transfer and Recordation Taxes**

**Estimated FY06 revenues of \$184.0 million are 6.8 percent below the revised FY05 estimate.** This reflects an FY06 estimate of \$113.0 million in the transfer tax and \$71.0 million in the recordation tax not including the portion for school construction. Transfer and recordation tax revenues have fluctuated greatly over time and are particularly sensitive to real estate market indicators. In FY04, nearly 88 percent of transfer tax revenue came from the residential sector with the remaining share from the commercial sector. The transfer tax rate is generally one percent of the value of the property transferred to a new owner. This applies to both improved (i.e., building) and unimproved (i.e., land) residential and commercial properties. The recordation tax is levied when changes occur in deeds, mortgages, leases, and other contracts pertaining to the title of either real or personal property. Through FY02 the recordation tax was generally \$4.40 per \$1,000 of the value of the contract. Beginning in FY03, the recordation tax rate was raised to \$6.90 per \$1,000 of the value of the contract with the first \$50,000 of the consideration exempted from the tax for owner-occupied residential properties. The Council intended that the revenues attributed to the rate increase be used for school construction. Generally, both transfer and recordation taxes are levied when properties are sold. In a few cases, only one of the two taxes is levied. One example is refinancing of a mortgage, in which case there may be an increase in the mortgage amount and, hence, recordation tax, but since there is no transfer of property, there is no transfer tax.

Residential transfer tax revenues are affected by the trends in real estate sales for existing and new homes. Real estate sales, in turn, are highly correlated with specific economic indicators such as growth in employment and wages and salaries, formation of households, and mortgage interest rates. Additionally, financial market conditions are increasingly affecting this trend, such as the beneficial impact that the “wealth effect,” resulting from unprecedented gains from the stock markets, has had on the real estate market in the late 1990s. The same holds true for the commercial sector, which is equally affected by business activity and investment, office vacancy rates, and financing costs. Even though economic conditions in the County were generally solid during the first half of the

1990s, the real estate market remained well below the fast growth trend observed in the late 1980s. In fact, following the 1990-91 recession the number of residential transfers continued to decline until that level dropped to a low of 14,800 transfers in FY97. The turnaround came at the onset of FY98 when the real estate market experienced a sharp rebound. At the close of FY98, residential transfers had jumped 15.4 percent, followed by an even stronger 19.5 percent growth in FY99. This trend was unsustainable considering the County’s demography with new household formation close to one percent annually. The volatility in revenues from the transfer and recordation is best illustrated in the trend since FY99. The growth rate in the number of transfers slowed to 7.5 percent in FY00 when the number of residential transfers peaked at 22,000, decreased 4.5 percent in FY01 (21,005), increased 12.5 percent in FY02 (23,640), decreased 3.3 percent in FY03 (22,838), and increased 9.1 percent in FY04 (24,912). While the number of transfers exhibited significant volatility since FY99, the recent acceleration in home prices has had a significant effect on revenues. Due to the strong demand for new and existing homes, property values continued to increase.

During the late 1990s, the “wealth effect” benefited the real estate market allowing many residents to purchase homes at the high end of the spectrum. Since that time, record low mortgage rates have been the economic driver behind the demand for such homes. This is reflected in an 80 percent jump in the average residential transfer tax between FY97 (\$2,113) and FY04 (\$3,806). Following the robust sales trend between calendar year 1997 and 1999, some moderation occurred in existing home sales in the period 2000-2004. One reason for the slower growth in existing home sales in the County is the shrinking inventory of homes – not a lack of demand. According to data from the National Association of Realtors, the number of existing home sales in the County, after increasing 10.0 percent (1997), 26.4 percent (1998), and 12.5 percent (1999), grew only 0.4 percent in 2000, 4.8 percent in 2001, 3.4 percent in 2002, 2.9 percent in 2003, and 7.4 percent in 2004. However, the deceleration in the growth of home sales was offset by the dramatic increase in prices. Since 2000, sales prices have experienced a meteoric rise from 8.4 percent in 2001, 16.6 percent in 2002, 13.2 percent in 2003, and 18.3 percent in 2004. With the expected decline in home sales coupled with a moderation in the growth of average home prices, revenues from the transfer tax are estimated to decrease \$6.3 million in FY06, or 5.3 percent, from the revised estimate for FY05.

At the same time that the residential sector improved sharply in FY98, revenues from non-residential properties began to fall in FY99 (-29%) and continued to fall through FY00 (-0.7%) to FY01 (-12.4%). However, based on a healthy commercial boom in calendar year 2001 and 2002, non-residential transfer taxes recovered in FY02, FY03, and FY04 as reflected in 10.2 percent, 10.0 percent, and 11.9 percent increases, respectively, in revenues. However, such increases are followed by a drop of 17.7

percent estimated for FY05, and a decrease of 35.3 percent projected in FY06. Part of the reason for the dramatic decline in the number and value of commercial transfers is the significant growth in new office space at a time that office vacancy rates climbed to a six-year high while employment is estimated to grow well below rates observed in the late 1990s and 2000.

Recordation tax revenues generally track the trend in transfer tax revenues. More recently, the relationship increased to approximately 90 percent of transfer tax. Such an increase is due to a record high level of mortgage refinancing, which impact the recordation tax, but not the transfer tax. Mortgage interest rates have fallen 33.0 percent (or nearly 300 basis points) since May 2000; hence revenues from the recordation tax increased 35.7 percent in FY02, 63.0 percent in FY03, 84.0 percent in FY04, and an estimate 1.6 percent in FY05. The current projection for FY06 reflects a decline of 9.0 percent from an all-time high base of \$112.6 million, which includes funds for school construction. Yet, with the projected decline in FY06, revenues from the recordation tax are expected to be the second highest. The combined transfer and recordation taxes are projected to reach \$184.0 million in FY06, excluding revenues for school construction, also the third highest behind the \$185.2 million in FY04 and an estimated \$197.5 million in FY05. Excluding that portion of the tax dedicated to school construction, revenues increased 17.7 percent in FY03, 27.8 percent in FY04, and an estimated 1.6 percent in FY05. This projection also assumes that the share of residential transfers increases to 95 percent over time, primarily due to rising home values. This is predicated on continued, albeit in the initial period, slower economic growth throughout the forecast period contributing to a further expansion of the employment base; household formation; and, hence, demand for new and existing homes in the County.

## **Energy Tax**

**Estimated FY06 revenues of \$117.6 million are 1.6 percent above the revised FY05 estimate.** The fuel-energy tax is imposed on persons transmitting, distributing, manufacturing, producing, or supplying electricity, gas, steam, coal, fuel oil, or liquefied petroleum gas. Different rates apply to residential and nonresidential consumption and to the various types of energy. Effective FY04, the previous rate schedule was increased threefold by the County Council on May 14, 2003; the first such change since FY96 but scheduled to "sunset" in FY06. The rate schedule was changed again by the County Council on May 20, 2004, with rates increasing 52.15 percent for FY05. The FY06 estimate assumes a repeal of the sunset provision enacted by the County Council. Since the rates per unit of energy consumed are fixed, collections change only with shifts in energy consumption and not due to changes in the price of the energy product. Measured by the number of units, residential usage as a share of the total has risen modestly over time to 49 percent by FY03, with the remaining 51

percent for non-residential entities. Due to a different rate schedule, the share of receipts from residential users is approximately 30 percent of total collections, with the remaining share received from the non-residential sector. Measured for all energy types, the two largest sources of revenues are electricity (75 percent) and natural gas (23 percent). Since actual collections vary with weather conditions, the harsh winter weather increases usage of electricity, natural gas, and heating oil, while the milder summer weather forecasted reduces electricity usage for climate control systems. The impact of weather patterns is partly offset by an expansion of the user base with more businesses and households. With a continuation of the "mild weather" pattern for the next fiscal year, the budget estimate for FY06 is projected to increase 1.6 percent.

## **Telephone Tax**

**Estimated FY06 revenues of \$29.1 million are 3.8 percent above the revised FY05 estimate.** The telephone tax is levied as a fixed amount per line and per wireless line. The tax on a traditional landline is \$2.00 per month, while multiple business lines (Centrex) are taxed at \$0.20 per month. The tax rate on wireless lines is \$2.00 per month. Both sets of rates were increased by the County Council on May 14, 2003, and effective FY04. Prior to FY04, traditional landlines were taxed at \$0.925, Centrex lines at \$0.0925, and wireless at \$0.000 per line. This is the first change in the rate schedule for land lines since FY96 and the first change for wireless lines since FY00. Collections will vary as new lines are installed in households or at business locations. In FY97, the law extended the tax to include wireless communication devices (e.g., cellular phones, and pagers). Effective FY00, the tax on wireless communication devices was repealed. With business expansion combined with a surge in new home sales in the County in FY00 and FY01, and an increased demand for second phone lines for computer access to the internet, collections from the telephone tax grew 12.0 percent in FY00 and 4.1 percent in FY01. With the slowdown in the local economy during FY02 and FY03 and alternative computer internet access, collections declined 5.8 percent and 8.6 percent, respectively. With the enactment of the rate increases and a modest growth in businesses and households, revenues are expected to increase 4.2 percent in FY05 to \$28.1 million. Reflecting, in part, modest growth in new household and business formations, the outlook for FY07 through FY11 is for landlines and wireless and, hence revenues, to increase at a slower rate attributed to a deceleration in the rate of household formations and a growing saturation of the market for wireless devices.

## **Hotel/Motel Tax**

**Estimated FY06 revenues of \$13.0 million are 1.2 percent above the revised FY05 estimate.** The hotel/motel tax is levied as a percentage of the hotel bill. The current tax rate of 7 percent in FY05 is also assumed for FY06. Collections grow with the costs of hotel rooms

and room supply and are affected by the hotel occupancy rate in the County. Occupancy rates in the County are generally the highest in the spring (April and May) and autumn (September and October) as tourists and schools visit the nation's capital for such events as the Cherry Blossom Festival and school trips, while organizations often schedule conferences during such periods. During peak periods, many visitors to Washington, D.C. use hotels in the County, especially those in the up-county area where rates are generally lower than in the District. Reflecting improved economic conditions during the mid and late 1990s and the presidential primaries and presidential inauguration during 2000 and early 2001, respectively, spurred both business travel and tourism, hotel occupancy rates grew from just under 67 percent in FY96 to a record high 72.3 percent in FY01. These rates are considered high according to industry experts and well above both the national rate of 65 percent and the break-even point of 60 percent for most hotels. The second component – average room rate – grew 34.4 percent between FY96 and FY01 to a record \$102.60. The third component that makes up revenues – room supply – grew by five percent between FY96 and FY01. As a result total hotel revenues doubled between FY96 and FY01 to over \$13.1 million.

However in the aftermath of the terrorist attacks on September 11, 2001, and war on terrorism, business travel and tourism were reduced significantly in the greater Washington region. In an effort to stimulate hotel occupancy, hotels dramatically cut room rates thereby reducing revenues in FY02 by over \$2 million compared to FY01. The rebound in hotel occupancy during FY04 allowed hotels to hold room rates steady, and recoup some of the losses made during FY02 and FY03. The revised estimated revenues for FY05 are solely attributed to an increase in the average room rate. Occupancy rates are expected to decline slightly to 63.5 percent in FY06, attributed to an increase in the supply of rooms. Room rates are expected to climb to \$107 as a countywide average, resulting in a 1.2 percent growth in the hotel/motel tax in FY06 which follows a revised estimate of 1.3 percent growth in FY05. Long-term estimates are tied to projected room occupancy and rate increases, partially reflecting the forecast of inflation and population growth that result in annual projected revenues through FY11 in the \$13.2 million and \$14.9 million range. The Montgomery County Conference and Visitors Bureau is funded, in part, through a 3.5 percent share of the hotel/motel tax.

### **Admissions Tax**

**Estimated FY06 revenues of \$2.7 million are 3.4 percent above the revised FY05 estimate.** Admissions and amusement taxes are State-administered local taxes on the gross receipts of various categories of amusement, recreation, and sports activities. Taxpayers are required to file a return and pay the tax monthly while the County receives quarterly distributions of the receipts from the State. Montgomery County levies a seven percent tax,

except for categories subject to State sales and use tax, where the rate is five percent. Such categories include rentals of athletic equipment, boats, golf carts, skates, skis, horses; and sales related to entertainment. Gross receipts are exempt from the County tax when a Municipal admissions and amusement tax is in effect. Coin and non-coin-operated amusement devices account for 20 percent of total collections, while other major categories include golf green fees, driving ranges and golf cart rentals (34 percent), motion picture theaters (35 percent), athletic events (e.g., the Booz Allen Classic Golf Tournament), refreshments and merchandise sold where there is entertainment, and athletic facilities or equipment. The admissions tax is negatively impacted by motion picture theaters located in municipalities, such as the popular Regal Cinemas in Rockville that draw visitors away from non-municipal theaters. As a result of these trends, the cinema share of total admission taxes has fallen steadily from 40 percent five years ago to 27 percent in FY02 but rebounded to 37 percent in FY03 and 35 percent in FY04. Revenue growth for the period FY07 through FY11 is expected to range between 3.0 percent and 4.0 percent, reflecting modest population growth.

## **NON-TAX REVENUES**

Non-tax revenues throughout all tax supported funds (excluding Enterprise Funds, such as Permitting Services, Parking Districts, Solid Waste Disposal, and Solid Waste Collection Funds) are estimated at \$654.1 million in FY06. This is a \$66.4 million increase, or 11.3 percent, from the revised FY05 estimate, reflecting a 16.9 percent increase in public school funding. Non-tax revenues include: intergovernmental aid; investment income; licenses and permits; user fees, fines, and forfeitures; and miscellaneous revenues, the largest of which is rental property income.

### **General Intergovernmental Aid**

General Intergovernmental Aid is received from the State or Federal governments as general aid for certain purposes, not tied, like grants, to particular expenditures. The majority of this money comes from the State based on particular formulas set in law. Total aid is specified in the Governor's annual budget. Since the final results are not known until the General Assembly session is completed and the State budget adopted, estimates in the March 15 County Executive Recommended Public Services Program are, generally, based on the Governor's budget estimates for FY06, unless those estimates assume a change in existing law. If additional information on the State budget is available to the Executive, this information will be incorporated into the budgeted projection of State aid. For future years, it is difficult to know confidently how State aid policy may change. The projection does not assume that State aid formulas will necessarily remain in place. It is assumed that State aid will increase with either the projected rate of inflation, by an amount based on the projected increase in County population, or a combination of those two factors. The Recommended Budget for FY06

assumes \$57.5 million, or 12.8 percent, increase in Intergovernmental Aid above the revised FY05 estimate, of which 62.4 percent is allocated to the Montgomery County Public Schools, 7.6 percent to Highway User Revenue, 5.0 percent to Mass Transit, and 4.6 percent to Montgomery College. The increase is attributed to an estimated \$45.6 million increase to public schools. Total Intergovernmental Aid is estimated to total \$504.9 million in FY06 or 77.2 percent of all non-tax revenues.

### **Licenses and Permits**

Licenses and permits include General Fund business licenses (primarily public health, traders, and liquor licenses) and non-business licenses (primarily marriage licenses and Clerk of the Court business licenses). Licenses and permits in the Permitting Services Enterprise Fund, which include building, electrical, and sediment control permits, are Enterprise Funds and thus not included in tax supported projections. Modest long-term growth is anticipated in these revenues, because some are based on relatively static factors such as the number of businesses, while others reflect general economic activity. The Recommended Budget for FY06 assumes a 4.8 percent growth over the revised projections for FY05, resulting in \$12.5 million in available resources in FY06.

### **Charges for Services (User Fees)**

Excluding intergovernmental revenues to Montgomery County public schools and college tuition, charges for services, or user fees, is the largest non-tax revenue source, especially when Enterprise Funds such as Solid Waste Collection, Solid Waste Disposal, Liquor Fund, M-NCPPC user fees, MCPS food service sales, and parking revenues are considered. Tax supported fee revenues come primarily from fees imposed on the recipients of certain County services including mass transit, human services, and recreation services and are included in the tax supported funds. Without rate increases, these revenues tend to show little growth although there is some variance because of weather, population changes, the economy, and changes in commuting patterns. However, it is the policy of the County to increase rates or fees to keep up with inflation. It is not always possible to achieve this goal for each fee, either because of market competition or because prices normally rise in rounded steps. The long-term estimates assume that rates will rise. The Recommended Budget for FY06 assumes 3.4 percent growth over the revised projections for FY05, resulting in \$46.9 million in available resources in FY06.

### **Fines and Forfeitures**

Revenues from fines and forfeitures relate primarily to photo red light citations, library, and parking fines (excluding the County's four Parking Districts). The Recommended Budget for FY06 assumes that fines and forfeitures will increase 5.1 percent over the revised estimates for FY05, resulting in \$10.4 million in available resources in FY06. All of the change from the revised

estimate is attributable to an increase in the photo red light citations and fees.

### **College Tuition**

Although College tuition is no longer included in the County Council Spending Affordability Guideline Limits (SAG), it remains in the tax supported College Current Fund. Calculation of the aggregate operating budget is under the SAG Limits. Tuition revenue depends on the number of registered students and the tuition rate. The projection assumes enrollment, as projected, and assumes that the tuition rate will increase. While the Board of Trustees has not yet taken final action on a tuition increase, a four dollar per credit hour increase for County residents is assumed in this projection, based on the revenues in the Board's recommended budget.

### **Investment Income**

Investment income includes the County's pooled investment and non-pooled investment and interest income of other County agencies and funds. The County operates an investment pool directed by an investment manager who invests all County funds using an approved, prudent investment policy as a guide. The pool includes funds from tax supported funds as well as from Enterprise Funds, municipal taxing districts, and other governmental agencies. Two major factors determine pooled investment income: (1) the average daily investment balance which is affected by the level of revenues and expenditures, fund balances, and the timing of bond and commercial paper issues; and (2) the average yield percentage which reflects short-term interest rates and may vary considerably during the year.

The revised FY05 estimate of pooled investment income of \$13.7 million assumes a 2.15 percent yield on equity and an average daily balance of \$637 million. The FY06 projected estimate of \$22.0 million assumes a modest improvement to a 3.00 percent yield and an average daily balance of \$702 million. Reflecting robust growth in revenues in the second half of the 1990s, the amount of available funds for investments, measured by the daily cash balance, doubled between FY93 (\$437 million) and FY00 (\$890 million). As a result of weak economic and revenue conditions starting in 2001, the cash balance declined from \$890 million to \$566 million between FY00 and FY04. Using current revenue projections, the daily cash balance is expected to grow from \$637 million in FY06 to \$940 million by FY11. Yields have fluctuated significantly over time. When the Fed tightened monetary policy in 1999 and 2000, yields jumped to 6.7 percent in the latter part of 2000 – a ten-year high. On a fiscal year basis, yield rates increased to 6.2 percent in FY01. However, as the economy weakened significantly in calendar year 2001, the Federal Open Market Committee (FOMC) of the Federal Reserve began an aggressive monetary policy and cut the federal fund interest rate 13 times, reducing the rate from 6.5 percent at the onset of

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2001 to just 1.00 percent by June 2003 – the lowest level since 1958. Not surprisingly, investment income yields followed interest rates on their downward trend, with the yield falling from 6.6 percent in December 2000 to 1.5 percent in December 2002. This 84 percent drop (or 554 basis points) in yield is the main reason for the 87 percent drop in investment income between FY00 and FY04. The FOMC is expected to maintain a measured pace in increasing the target rate on federal funds. As a result, yields are expected to climb to 3.00 percent by the end of FY05 and to 5.25 percent by FY11.

### ***Other Miscellaneous***

The County receives miscellaneous income from a variety of sources, the largest of which are rental income for the use of County property, prior year encumbrance liquidations, and abandoned vehicle auctions. These three categories make up 67.5 percent of the total \$8.8 million projected for FY06. The projection for subsequent fiscal years assumes growth at the rate of inflation.